

## Internal Revenue Service, Treasury

## § 1.937-3T

(ii) A Corp owns 50 percent of the outstanding shares of B Corp, a corporation organized under the laws of Country FC. During 2004 through 2006, B Corp has gross income from the following sources:

Year	Possession I sources	Sources outside possession I
2004 .....	\$10x	\$6x
2005 .....	14x	8x
2006 .....	10x	4x

(iii) A Corp is treated as having received 50 percent of the gross income of B Corp. Therefore, for 2004 through 2006, the gross income of A Corp is from the following sources:

Year	Possession I sources	Sources outside possession I
2004 .....	\$15x	\$23x
2005 .....	27x	14x
2006 .....	30x	17x
Totals .....	72x	54x

(iv) Pursuant to paragraph (g) of this section, the portion of the dividend of \$70x that X receives from Corp A in 2006 that is treated as income from sources within Possession I is 72/126 of \$70x, or \$40x.

*Example 5.* X is a U.S. citizen and a bona fide resident of the Northern Mariana Islands (NMI). In 2005, X receives compensation for services performed as a member of the crew of a fishing boat. Ten percent of the services for which X receives compensation are performed in the NMI, and 90 percent of X's services are performed in international waters. X is a "United States person" as defined in section 7701(a)(30)(A). Accordingly, pursuant to section 863(d)(1)(A), the compensation that X receives for services performed in international waters is treated as income from sources within the United States for purposes of the Internal Revenue Code (including section 7654, as in effect with respect to the NMI). Under the principles of section 861(a)(3) as applied pursuant to paragraph (b) of this section, the compensation that X receives for services performed in the NMI is treated as income from sources within the NMI.

(1) *Effective date.* Except as otherwise provided in this paragraph (1), this section applies to income earned in tax years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (f) of this section applies to dispositions after April 11, 2005. Paragraphs (c)(2), (g)(1), (h), and (i) of

this section apply to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18942, Apr. 11, 2005]

**§ 1.937-3T Income effectively connected with the conduct of a trade or business in a possession (temporary).**

(a) *Scope.* Section 937(b) and this section set forth the rules for determining whether income is effectively connected with the conduct of a trade or business within a particular possession (the relevant possession) for purposes of the Internal Revenue Code, including sections 881(b) and 957(c) and Subpart D, Part III, Subchapter N, Chapter 1 of the Internal Revenue Code. Paragraph (c) of this section does not apply, however, for purposes of section 881(b). In the case of a possession or territory that administers income tax laws that are identical (except for the substitution of the name of the possession or territory for the term *United States* where appropriate) to those in force in the United States, these rules do not apply for purposes of the application of such laws.

(b) *In general.* Except as provided in paragraphs (c) and (d) of this section, the principles of section 864(c) and the regulations thereunder (relating to the determination of income, gain or loss which is effectively connected with the conduct of a trade or business within the United States) shall generally be applied in determining whether income is effectively connected with the conduct of a trade or business within the relevant possession (except for the substitution of the name of the relevant possession for the term *United States* where appropriate), without regard to whether the taxpayer qualifies as a nonresident alien individual or a foreign corporation with respect to such possession. For purposes of the preceding sentence, all income other than income from sources within the relevant possession (as determined under the rules of § 1.937-2T) shall be considered income from sources without the relevant possession, and subject to the rules of this section, the principles of section 864(c)(4) shall apply for purposes of determining whether such income constitutes income effectively

connected with the conduct of a trade or business in the relevant possession.

(c) *U.S. income*—(1) *In general.* Except as provided in paragraph (d) of this section, income considered to be effectively connected with the conduct of a trade or business within the relevant possession shall not include any item of income determined under the rules of sections 861 through 865 and the regulations thereunder to be—

(i) From sources within the United States; or

(ii) Effectively connected with the conduct of a trade or business within the United States.

(2) *Conduit arrangements.* Income shall be considered to be from sources within the United States for purposes of paragraph (c)(1) of this section if, pursuant to a plan or arrangement—

(i) The income is received in exchange for consideration provided to another person; and

(ii) Such person (or another person) provides the same consideration (or consideration of a like kind) to a third person in exchange for one or more payments constituting income from sources within the United States.

(d) *Income from certain sales of inventory property.* Paragraph (c) of this section shall not apply to income from sales of inventory property described in § 1.863-3(f).

(e) *Examples.* The provisions of this section may be illustrated by the following examples:

*Example 1.* X is a bona fide resident of Possession I, a section 931 possession (as defined in § 1.931-1T(c)(1)). X has an office in Possession I from which X conducts a business consisting of the development and sale of specialized computer software. A purchaser of software will frequently pay X an additional amount to install the software on the purchaser's operating system and to ensure that the software is functioning properly. X performs the installation services at the purchaser's place of business which may be in Possession I, in the United States, or in another country. The provision of such services is not *de minimis* and constitutes a separate transaction under the rules of § 1.861-18. Under the principles of section 864(c)(4) as applied pursuant to paragraph (b) of this section, the compensation that X receives for personal services performed outside of Possession I is not considered to be effectively connected with the conduct of a trade or

business in Possession I for purposes of section 931(a)(2).

*Example 2.* (i) F Bank is organized under the laws of Country FC and operates an active banking business from offices in the U.S. Virgin Islands (USVI). In connection with this banking business, F Bank makes loans to and receives interest payments from borrowers who reside in the USVI, in the United States, and in Country FC.

(ii) Under the principles of section 861(a)(1) as applied pursuant to § 1.937-2T(b), interest payments received by F Bank from borrowers who reside in the United States or in Country FC constitute income from sources outside of the USVI. Under the principles of section 864(c)(4) as applied pursuant to paragraph (b) of this section, interest income from sources outside of the USVI generally may constitute income that is effectively connected with the conduct of a trade or business within the USVI for purposes of the Internal Revenue Code. However, interest payments received by F Bank from borrowers who reside in the United States constitute income from sources within the United States under section 861(a)(1). Accordingly, under paragraph (c)(1) of this section, such interest income shall not be treated as effectively connected with the conduct of a trade or business in the USVI for purposes of the Internal Revenue Code (for example, for purposes of section 934(b)). Interest payments received by F Bank from borrowers who reside in Country FC, however, may be treated as effectively connected with the conduct of a trade or business in the USVI for purposes of the Internal Revenue Code (including section 934(b)).

(iii) To the extent that, as described in section 934(a), the USVI administers income tax laws that are identical (except for the substitution of the name of the USVI for the term *United States* where appropriate) to those in force in the United States, interest payments received by F Bank from borrowers who reside in the United States or in Country FC may be treated as income that is effectively connected with the conduct of a trade or business in the USVI for purposes of F Bank's income tax liability to the USVI under mirrored section 882.

*Example 3.* (i) G is a partnership that is organized under the laws of, and that operates an active financing business from offices in, Possession I. Interests in G are owned by D, a bona fide resident of Possession I, and N, an alien individual who resides in Country FC. Pursuant to a pre-arrangement, G loans \$x to T, a business entity organized under the laws of Country FC, and T in turn loans \$y to E, a U.S. resident. In accordance with the arrangement, E pays interest to T, which in turn pays interest to G.

(ii) The arrangement constitutes a conduit arrangement under paragraph (c)(2) of this

section, and the interest payments received by G are treated as income from sources within the United States for purposes of paragraph (c)(1) of this section. Accordingly, the interest received by G shall not be treated as effectively connected with the conduct of a trade or business in Possession I for purposes of the Internal Revenue Code (including sections 931(a)(2) and 934(b), if applicable with respect to D). Whether such interest constitutes income from sources within the United States for other purposes of the Internal Revenue Code under generally applicable conduit principles will depend on the facts and circumstances. See, for example, *Aiken Indus., Inc. v. Commissioner*, 56 T.C. 925 (1971).

(iii) If Possession I administers income tax laws that are identical (except for the substitution of the name of the possession for the term “United States” where appropriate) to those in force in the United States, the interest received by G may be treated as income effectively connected with the conduct of a trade or business in Possession I under mirrored section 864(c)(4) for purposes of determining the Possession I territorial income tax liability of N under mirrored section 871.

(f) *Effective date.* Except as otherwise provided in this paragraph (f), this section applies to income earned in taxable years ending after October 22, 2004. Paragraph (c)(1) of this section applies to income earned after December 31, 2004. Paragraph (c)(2) of this section applies to amounts paid or accrued after April 11, 2005.

[T.D. 9194, 70 FR 18944, Apr. 11, 2005; 70 FR 32490, June 3, 2005]

#### CHINA TRADE ACT CORPORATIONS

##### § 1.941-1 Special deduction for China Trade Act corporations.

In addition to the deductions from taxable income otherwise allowed such a corporation, a China Trade Act corporation is, under certain conditions, allowed an additional deduction in computing taxable income. This special deduction is an amount equal to the proportion of the taxable income derived from sources within Formosa and Hong Kong (determined without regard to this section and determined in a manner similar to that provided in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder) which the par value of the shares of stock of the corporation, owned on the last day of

the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, bears to the par value of the whole number of shares of stock of the corporation outstanding on that date. The decrease, by reason of such deduction, in the tax imposed by section 11 must not, however, exceed the amount of the special dividend referred to in section 941 (b), and is not allowable unless the special dividend has been certified to the Commissioner by the Secretary of Commerce.

##### § 1.941-2 Meaning of terms used in connection with China Trade Act corporations.

(a) A China Trade Act corporation is one organized under the provisions of the China Trade Act, 1922 (15 U.S.C. chapter 4).

(b) The term “special dividend” means the amount which is distributed as a dividend to or for the benefit of such persons as on the last day of the taxable year were resident in Formosa, Hong Kong, the United States, or possessions of the United States, or were individual citizens of the United States, and owned shares of stock of the corporation. Such dividend must be distributed prior to or at the time fixed by law for filing the return of the corporation, including the period of any extension of time granted under rules and regulations prescribed by the Commissioner with the approval of the Secretary or his delegate. Such special dividend does not include any other amounts payable or to be payable to such persons or for their benefit by reason of their interest in the corporation and must be made in proportion to the par value of the shares of stock of the corporation owned by each.

(c) For the purposes of section 941, the shares of stock of a China Trade Act corporation are considered to be owned by the person in whom the equitable right to the income from such shares is in good faith vested.

(d) “Taxable income derived from sources within Formosa and Hong Kong” is the sum of the taxable income from sources wholly within Formosa and Hong Kong and that portion of the